

# HAWAII CONDOMINIUM BULLETIN

VOLUME 3 NO. 4

SPRING 1994

Funded through the Condominium Management Education Fund, Hawaii Real Estate Commission, State of Hawaii

## IRS Cautions Associations About the Tax Treatment of Excess Maintenance Fees

### Note to readers

On February 11, 1994, the public affairs officer, Hawaii District Office, Internal Revenue Service distributed the information reprinted below.

The Internal Revenue Service today cautioned homeowners associations about the tax treatment of excess maintenance fees collected during 1993. According to the IRS, current tax law does not provide for the tax free "rolling over" of these excess collections to future tax years if the associations file as a corporation using Form 1120, the corporate income tax return.

According to the IRS, a 1970 IRS ruling (Revenue Ruling 70-604) has

been interpreted erroneously by some associations to mean that excess maintenance fees collected during any tax year can be carried over, tax free, to future tax years until such time as they are expended. The result of this erroneous interpretation is that these associations have accumulated substantial amounts of monies that have never been taxed.

The ruling states that a homeowners association filing as a corporation would not have to include any excess maintenance fees collected in its gross income if the excess is either refunded to the members of the association or applied against the following year's assessments for maintenance. The IRS says that "application against the following year's assessments" means that the following year's payments for maintenance by the members of the association would be reduced by each

homeowners' proportionate share of the previous year's excess.

The net effect of refunding the excess or applying it to the next year's maintenance fees is that the excess collected has been returned to the members of the association, and the association would not be responsible for taxes on income it has returned or otherwise refunded to its members.

The Internal Revenue Service recommends that associations with excess maintenance fees consult with their tax advisors as to the proper tax treatment of any such excess and consider whether they will file as a corporation or file as a homeowners association, using Form 1120H, the tax return specifically for homeowners associations.

As a corporation filing the 1120, the association pays tax on all income at a graduated rate, beginning at 15%. Filing as a homeowners association with the 1120H, the qualifying association pays a flat 30% tax on interest and unrelated income, but does not pay tax on the dues set aside for reserves.

On February 5th, Grant Kawamoto, Technical Coordinator,

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## Letter from the Vice Chair. . .

Dear Condominium Owners,

During late winter and early spring, many associations hold their annual meetings. To those directors newly elected or reelected, I offer my congratulations. To those who have served, I extend my regards for your past hard work. To both, my gratitude for your willingness to serve and to assist in the self-governance of your respective associations.

I also wish to commend the one hundred or so individuals who attend the fiduciary duty seminar presented on Saturday morning, February 26th. Unfortunately, the February 19th seminar (in Kona) which was rescheduled was again cancelled due to lack of sufficient registration.

The response to the condominium reference library kits has been positive. For those who have not seen it, please call your nearest branch of the Hawaii state library to inquire about hours of availability. The condominium reference library kit includes more than thirty specialized brochures and books with details about condominium management and governance. For a list of titles included, please see the Fall 1993 issue of the Hawaii Condominium Bulletin. Newly elected presidents or treasurers may wish to review especially the brochures about reserves and their respective roles.

Please feel free to write to or call (586-2646 or from the Neighbor Islands, 1 800 468-4644, extension 6-2646) the Commission's condominium specialists.

Very truly yours,

Carol Mon Lee,  
Vice Chair, Condominium and  
Cooperative Review Committee

## Ask the Condominium Specialists

**Q.** My association always seems to have disagreements or disputes between board members, between the board and the owners and between owners. What can we do?

**A.** The original intent and policy of the Legislature for condominium associations was for self-management and self-governance. That is, each condominium association should decide on its own, with little interference by government on how to manage its own affairs.

However, to foster civility and assist in dispute resolution, the board should consider using alternative dispute resolution ("ADR") procedures such as conciliation, mediation, or arbitration. These procedures benefit the association because problem solving can be simpler, faster, and less expensive. Adoption of these procedures may require a board resolution or amendment of the association's governing documents.

In addition, you may wish to review a booklet entitled "Resolving Association Disputes", by Vivian Walker, a copy of which is available in the Condominium Reference Library kit, which may be available at the Hawaii State Library. Since it may be a reference only item, you may wish to call ahead to confirm availability or hours of operation.

If you wish to request a mediation, call the Neighborhood Justice Center at 521-6767 or Mediation Services of Maui at 244-5744.

# Fiduciary Duties

**D**irectors of condominium associations generally are volunteers with a big job. The “big job” was previously described in the publication, *Condominium Board Members Powers and Duties*, on page 29, and includes<sup>1</sup>:

*“The board of directors has broad authority to manage the affairs of the condominium association. The board governs the association, establishes policies and rules, ensures the accuracy of financial and administrative records, maintains the common elements and promotes a quality environment for all residents...”*

In carrying out this big job, directors have repeatedly heard that each owes the association of apartment owners a “fiduciary duty”.<sup>2</sup> What is this duty? The term “fiduciary duty” may seem like a lot of mumble jumble legal jargon beyond the comprehension of the lay director.

Nevertheless, it may be easily understood when viewed as a “bundle of obligations.” The Hawaii Real Estate Education and Research Center, in its publication “Fiduciary Duty” (a section of the Board of Directors Guide) has attempted to explain the “Fiduciary Duty” as a bundling of the following obligations:

- ▶ obedience
- ▶ diligence (due care)
- ▶ loyalty
- ▶ good faith

When directors satisfy these obligations in managing the affairs of the association, it could be said that the director has met the director’s fiduciary

duty. In fulfilling the director’s fiduciary duty, the director decreases exposure to personal liability for actions taken on the board.

**These fiduciary duties or obligations require the director to:**

- ☞ **obey** the requirements and procedures set forth in the condominium property regime statutes, declarations, bylaws, rules, association policies, relevant other laws and ordinances;

## EXAMPLES

- ☞ Conducting a reserve study in compliance with §514A-83.6, HRS;
- ☞ Mandating the removal of a patio awning in accordance with the adopted administrative rules;

- ☞ exercise **diligence** or due care in arriving at a business, administrative or management decision for the benefit of the association (in being diligent, a director is expected to act like any other reasonable prudent director would under similar circumstance);

## EXAMPLES

- ☞ Gathering (researching, investigating) all necessary information for decision making;
- ☞ Consulting the opinions of appropriate professionals where necessary (i.e., legal counsel, engineers, architects, managing agents, parliamentarians, certified public accountant, etc.);

☞ be *loyal* to the association of apartment owners; to make decisions for the benefit of the association and not for direct or indirect benefit of the director, another board member, or a select group of association members (in remaining loyal to the association of apartment owners, the director avoids any conflicts of interest). The duty includes the obligations:

- to refrain from competing with the association; e.g. abstaining from bidding against the association at a foreclosure sale on a unit the association is attempting to buy, abstaining from bidding against the association in its efforts to acquire a piece of real property on which to erect a tennis court (where such acquisition is permitted);
- to refrain from taking advantage of an association opportunity; e.g., hiring a person as a full-time employee for one's own business when the association still has that person under active consideration as a full-time employee;
- to refrain from acquiring any real or personal property when one has reason to know that the association is interested in buying it (where such acquisition is permitted), e.g. submitting a bid for a foreclosed apartment when the association passed a resolution to acquire the apartment for use by its resident manager;
- to avoid conflicts of interests; e.g. abstaining from voting to purchase insurance from a firm in which one is a shareholder.<sup>3</sup>

- to manage the affairs of the association fairly.

#### EXAMPLES

- ☞ Voting to deny an owner's request for alterations to the exterior of his or her unit based on the project documents and a set criteria even though the owner is a friend and business associate.
- ☞ Initiating assessment proceedings against a board member in accordance with:
  - a board approved criteria;
  - governing documents; and or
  - statutes;

☞ act in *good faith*, having an honest belief that the action taken is necessary for the benefit of the association; malicious actions aimed at a particular individual or individuals are not good faith actions.

#### EXAMPLES

- ☞ Approving a higher bid for repaving the driveway because the proposed materials were of a higher quality rather than approve the next lower bid;
- ☞ Exercising independent judgement in approving the salary of a director (of a for-profit corporation) despite the fact that the board member is a trusted friend.

A more detailed discussion on the subject of "Fiduciary Duty" is available.

<sup>1</sup>Hawaii Real Estate Commission, 1991. *Condominium Board Members Powers and Duties*, Honolulu, Hawaii.

<sup>2</sup>§514A-82.4, Hawaii Revised Statutes.

<sup>3</sup>Robert G. Natelson, *Law of Property Owners Associations* (Boston: Little, Brown and Company, 1989), 482.

## Suggestions for Minimizing Directors' Personal Liability

1. Serve one principal—the association.
2. Make decisions for one mission—health, happiness, welfare of the condominium association and the preservation of the condominium common elements for decades to come.
3. Rise above self-interest.
4. Make decisions based on information, research, professional consultation where required; in arriving at a decision act independently and not at the direction and dominance of another board member.
5. Act prudently in making decisions, do what the “Reasonable Person would suggest and do under like circumstances.”
6. Be knowledgeable of the affairs of the association, this includes having a working knowledge of:
  - the association’s minutes, policies and governing documents—declaration, bylaws, and house rules; and
  - the condominium statute, Chapter 514A, HRS, and other related administrative rules, decisions and policies of the Real Estate Commission.
7. Be responsive to the residents you serve. This may include surveying the residents’ opinions on appropriate issues.
8. Consult experts when you are unfamiliar with the issues; i.e., attorneys specializing in condominium governance and administration, accountants, reserve specialists, contractors, electricians, plumbers; etc.
9. Consult more than one expert to insure that you have gathered information on which to base your decision; but remember that intentionally shopping around for a pre-selected biased opinion may not be deemed reasonable.
10. Attend continuing education courses and other seminars relating to managing the affairs of the association.
11. Keep abreast and be aware of court decisions, legislation, new federal and state laws, and county ordinances.
12. Hire managing agents and resident managers after a thorough investigation including applicable license history, reputation in the community, and reasonable prices for professional services rendered (seek more than one bid for any job).
13. Amend declaration and bylaws if necessary, to include provisions for the association to be responsible for costs and reasonable attorney’s fees incurred in defending oneself for the good faith decisions made while serving on the board (association may provide for this by indemnification and directors’ and officers’ insurance).
14. Give clear directions to the association’s officers, employees and agents as to the scope and limitations of their duties and responsibilities.
15. Review the performance of the association’s agents and implement procedures to prevent activities beyond the scope and authority of the duties delegated.

# Directory of Services

## Chapter 514A, HRS and Chapter 107 HAR, Copies

**DCCA Cashier ..... 586-2832**

Available by mail or over the counter from the cashier. No telephone requests. Call only to verify availability or latest cost. Requests in writing or in person, must be accompanied by a check for the correct amount, made payable to Commerce and Consumer Affairs.

Mailing Address:

Cashier — DCCA,  
Post Office Box 541  
Honolulu, Hawaii 96809

Office Address:

1010 Richards Street, Third Floor, Honolulu

## Complaints

### Regulated Industries Complaints Office (RICO)

Filing complaints against real estate licensees, condominium managing agents, condominium hotel operators, specific provisions of condominium property regime (CPR), time share and unlicensed or unregistered regulated areas. .... **587-3222**

History and information about complaints against real estate licensees, condominium managing agents, and condominium hotel operators. .... **586-2677**

Office and mailing address:

828 Fort Street Mall, Suite 600A  
Honolulu, Hawaii 96813

## Condominium Arbitration Service

**American Arbitration Association ..... 531-0541**

Inquiries and requests for arbitration service.

Office and mailing address:

810 Richards Street, Suite 641  
Honolulu, HI 96813

## Condominium Mediation Service

Inquiries and requests for mediation service.

**Neighborhood Justice Center ..... 521-6767**

Office & mailing address:

200 North Vineyard, Suite 320  
Honolulu, Hawaii 96817

**Mediation Services of Maui ..... 244-5744**

Cameron Center, 95 Mahalani Street  
Wailuku, Hawaii 96793

## Housing Discrimination

**Hawaii Civil Rights Commission ..... 586-8636**

Inquiries and complaints of discrimination in real property transactions.

Office & mailing address:

888 Mililani Street, Second Floor  
Honolulu, Hawaii 96813

**Housing & Urban Development (HUD) ..... 541-1897**

Inquiries and complaints of discrimination in real property transactions.

Office & mailing address:

Seven Waterfront Plaza, Suite 500  
500 Ala Moana Boulevard  
Honolulu, Hawaii 96813

## Toll Free State Government Number

From the Neighbor Islands, dial the toll free number and request to be connected to state government offices on Oahu. .... **1-800-468-4644**

## Landlord-Tenant Code

**Office of Consumer Protection ..... 586-2634**

Landlord-tenant inquiries, complaints, and requests for copies of handbook.

Office & mailing address:

828 Fort Street Mall, Suite 600B  
Honolulu, Hawaii 96813

## Leasehold Disclosure

**Housing Finance Development Corporation ..... 587-0500**

Inquiries about leasehold disclosure or requests for leasehold disclosure booklet.

**Land Programs Branch.**

Office & mailing address:

677 Queen Street, Suite 300  
Honolulu, Hawaii 96813

**Licensing Branch, DCCA ..... 586-3000**

Verification of license or registration status of real estate licensees, condominium managing agents, and condominium hotel operators.

Mailing address:

Post Office Box 3469  
Honolulu, Hawaii, 96801.

Office address:

1010 Richard Street, First Floor, Honolulu

## Real Estate Branch, DCCA

**Condominium Specialists ..... 586-2646**

Condominium governance/management inquiries, Chapter 514A, Condominium & Cooperative Review Committee.

**Condominium Specialists ..... 586-2644**

Condominium project registration/public reports, association registration, managing agent registration, applications/forms.

Office and mailing address:

250 South King Street, Rm 702  
Honolulu, Hawaii 96813

**Small Claims Court:** Inquiries about filing claims should be directed to the district court in your area. Consult the Hawaii State Government section of the telephone directory under the heading: "Courts — District"

## Time Sharing

**Inquiries and registration ..... 586-2709**

## Uniform Land Sales Practice Act (Subdivision), or Appraiser

**Registration, Certification, and Licensing ..... 586-2704**

Mailing address:

Post Office Box 3469  
Honolulu, Hawaii 96801

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Examination Division, Hawaii District, Internal Revenue Service spoke at a seminar presented by the Hawaii Council of Associations of Apartment Owners. The IRS representative discussed Hawaii's condominium reserve statute (§514A-83.6, Hawaii Revised Statutes) and proposed rules. He has received information from the IRS national office but has not yet received a definitive ruling. In responding to questions about the taxation of replacement reserves, the IRS representative said that for associations not filing under §528, Internal Revenue Code, (i.e., not using the 1120-H form) there is a very high likelihood that

replacement reserves would be considered taxable income, given the current Hawaii statute and its proposed rules. In prior IRS rulings, special assessments for capital purposes have been deemed not taxable as income only if the funds are specifically earmarked, if there is a fiduciary relation, if the board has only a ministerial role, and if it is a contribution to capital (with an equity or ownership relation). The IRS representative noted that the present Hawaii statute and proposed rules allow; a board to use reserve funds for other purposes in an emergency, would allow the board even if there were no emer-

gency to change the use of reserve funds subject only to notice to the owners, and provide that the reserve fund is not the property of the owner but the property of the association. Moreover, even if a board or association were to restrict its use of the reserve funds, the preempting clauses in the Hawaii statute (§514A-83.6(g)) might permit those restrictions to be overridden.

In addition, the IRS representative noted major concern over misinterpretation of Revenue Ruling 70-604 which the IRS views as a onetime rollover only to the next year's assessment. It was recommended that asso-

ciations consult competent tax counsel such as a CPA or tax attorney familiar with homeowner associations.

In discussing the rollover, the IRS representative provided three examples of calculations (see Taxation of Homeowners Associations' Handout reprinted here). In the first example, an association with \$400,000 in maintenance fees less certain adjustments would owe \$27,320 using the regular corporate rates (using form 1120). In the second example, an association with the same maintenance fees and deductions would owe \$6,900 if it chose to file the homeowners association form (1120-H). In the third example, which is subject to challenge, the association files form 1120, use the regular corporate rates, rolls over any maintenance fees in excess of operating expenses, and calculates that it owes only \$3,450.

Taxation of Homeowners Associations' Handout					
	Regular Corporate Tax Computation		Section 528 Election Tax Computation		Questionable Corporate Tax Computation
Income:					
Income From Maintenance Fees:	\$400,000		•		\$400,000
Income From Investments:	\$25,000		\$25,000		\$25,000
Other Income:	\$5,000		\$5,000		\$5,000
Total Income:		\$430,000		\$30,000	\$430,000
Expenses:					
Maintenance Expenses Paid or Incurred	\$310,000		•		\$310,000
Expenses Attributable to Investments:	\$7,000		\$7,000		\$7,000
Adjustment Pursuant to Rev. Rul. 70-604	\$0		\$0		\$90,000
Total Expenses:		\$317,000		\$7,000	\$407,000
Taxable Income:		\$113,000		\$23,000	\$23,000
Regular Corporate Tax Computation					
15% of the first \$50,000	\$7,500		n/a		\$3,450
25% of the next \$25,000	\$6,250		n/a		n/a
34% of the next \$25,000	\$8,500		n/a		n/a
39% of the balance	\$5,070		n/a		n/a
Section 528 Tax Computation					
30% of Taxable Income	n/a		\$6,900		n/a
Total Tax:		\$27,320		\$6,900	\$3,450

This material can be made available for individuals with special needs. Please call the Senior Condominium Specialist at 586-2644 to submit your request.

## Education Calendar

This listing reports the availability of some condominium governance related events. The Hawaii Real Estate Commission and the Hawaii Real Estate Research and Education Center **express no opinion** about the quality or content of any event which they do not sponsor; neither should the listing be construed as an endorsement or sponsorship of any event by the Hawaii Real Estate Commission or the Hawaii Real Estate Research and Education Center, unless expressly indicated. Interested parties are advised to conduct their own investigation and formulate their own opinion about these matters. Participants are advised that courses are subject to change, please check directly with the provider about the specifics of a particular event.

Date	Time	Course Title	Location	Provider
03/25/94	9-12:00 a.m.	"Your Reserve Funds—Safe or Sorry"	Maui Inter-Continental Hotel	SMCC
04/19/94	6:00 p.m.	Purchase, Ownership & Management of Condominiums (Course #L9869)	University of Hawaii (Manoa)	UH-SBMP
04/22-5/1	8:00 a.m.	Successful Site Management (Course #101)	Iolani Court Plaza, Oahu	IREM
04/23/94	7:30 a.m. – 3:50 p.m.	HSAP 28th Annual Seminar	Ala Moana Hotel, Carnation Room, Oahu	HSAP
06/21/94	6-9:30 p.m.	Purchase, Ownership, & Management of Condos (Kenneth Chong, instructor)	University of HI, College of Business Administration, A101	UH-SBMP
07/19/94	6-9:30 p.m.	Purchase, Ownership, & Management of Condos (Kenneth Chong, instructor)	University of HI, College of Business Administration, A101	UH-SBMP

**For full information for the above-listed courses, please call the Provider.**

Provider	Phone	Address
HSAP – Hawaii State Association of Parliamentarians	955-7522 (Oahu) Ask for Rita	1650 Ala Moana Blvd., Suite 511, Honolulu, HI 96815
CAI – Community Associations Institute Hawaii Chapter	531-6836 (Oahu)	P.O. Box 976, Honolulu, HI 96808
HREREC – Hawaii Real Estate Research & Education Center	956-7892 (Oahu)	2404 Maile Way B-201, Honolulu, HI 96822
IREM – Institute of Real Estate Management Hawaii Chapter No. 34	737-4000 (Oahu)	1136 12th Ave., Suite 220, Honolulu, HI 96816
SMCC – South Maui Condominium Council	879-2758 (Maui)	P.O. Box 647, Kihei, HI 96753
UH-SBMP – Small Business Management Program University of Hawaii	956-7363 (Oahu)	2404 Maile Way, Room A-202, Honolulu, HI 96822

### Do you have a condominium problem? Mediation may be the solution.

To support the condominium statute's provisions for owner enforcement and association self-governance, the Real Estate Commission sponsors a mediation program to bring disputing parties together to discuss their condominium problems. The program is operated through the Neighborhood Justice Center and through Mediation Services of Maui. Specially selected mediators assist the parties in communicating about the issues, exploring possible solutions, and negotiating mutually acceptable settlements. Mediators do not impose solutions on parties to a dispute but try to help them reach their own solutions. If necessary, mediation services are provided on the Neighbor Islands.

On Maui contact  
Mediation Services of Maui, Inc.  
Cameron Center, 95 Mahalani St  
Wailuku, Maui. Phone: 244-5744.

For all other islands contact:  
Neighborhood Justice Center  
200 North Vineyard Boulevard, Suite 320  
Honolulu, HI Phone: 521-6767

For further information, call the Commission at 586-2646 (Toll free from the neighbor islands only: 1-800-468-4644, ask for extension 62646).

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